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The influence of institutional environment on venture capital development in emerging economies: the example of Nigeria¹

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Main message: Venture capital can be nurtured in the right environment to be attractive to private venture capital development.

Key Points:

Venture capitalists require stable institutional frameworks, regulations and tax regimes alongside clear exit strategies.

Informal institution such as networking is important for venture capital development.

Governments of emerging economies need to stimulate entrepreneurial awareness of equity finance through training and promotion to facilitate investment readiness.

Introduction

Emerging economies are characterised by institutional changes as their economies start to develop (Urban & Kujinga, 2017). How institutional environments of emerging economies influence the venture capital (VC) development process has only just begun to be addressed (Li & Zahra, 2012; Lingelbach, 2015).

Notwithstanding the proliferation of studies examining the effect of institutional environment on the VC process, the theoretical framework has still not been sufficiently developed

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(Lingelbach, 2015). Therefore, this article explores how institutional environment impacts on VC development in emerging economies and how individuals and organisations can respond to those institutions (Lounsbury & Crumley, 2007). Despite the significance of VC in mature economies, emerging economies are lagging behind in VC development. Lingelbach (2015) suggests that the influence of institutions on VC activity can be of special relevance in emerging economies. Thus, VC in developing countries offers a natural laboratory for investigation of the impact of institutions on entrepreneurial activity.

Emerging economies typically have institutional environments that are considerably different from those of more developed economies (He et al., 2007). In particular, emerging economies tend to have inadequate regulatory and enforcement regimes (Peng, 2000). They have under-developed and inadequately enforced laws to support the fulfilment of contracts. Therefore, companies tend to pursue alternative, less formal, mechanisms such as relying on personal relationships and guarantees to ensure that parties fulfil obligations (Scott, 2002). Consequently, emerging economies offer a useful setting for understanding the impact of institutions on a given industry undergoing a swiftly changing environment (Bruton et al., 2010; Marcotte, 2014).

The benefit of focusing on the single subject of VC is that institutions are typically situation specific. Therefore, one can evaluate institutional characteristics with regard to a specific phenomenon such as an entrepreneurial system, rather than in terms of general arrangements (Busenitz et al., 2000; Muhammad et al., 2016).

VC is a widely used form of financial intermediation that is particularly well suited to stimulate the development of innovative fast-growing businesses that can make an impact on the

local/national economy. It is a niche form of financing which is most established in the US and UK, but even in these countries it is only around 2% of SMEs with potential high growth (PHG) that use VC (North et al, 2013). However, in Nigeria's emerging economy there are PHGs which are underfunded and therefore offer potential role for VC. VC requires an ecosystem building approach, enshrined in Gilson's simultaneity theory of engineering VC, with a balance between encouraging a pipeline of suitable businesses and the right environment for it to flourish (Gilson, 2003; Lerner, 2010).

The paper investigates the development of VC in Nigeria, an emerging economy lacking the fully-developed legal and financial institutions necessary to support flourishing sustainable VC financing. It explores two research questions: (i) How does institutional environment influence VC development in an emerging economy? (ii) Where there is apparent institutional deficit how might this be addressed to improve the operation of VC? To achieve this, the paper investigates the demand for and supply of VC within an institutional framework context, focusing on:

- The attitude of Nigerian-based entrepreneurs in attracting VC funding;
- What VCs look for when deciding on a venture in which to invest.

The study contributes to the literature on VC and institutions by providing a more fine-grained analysis of the impact of institutions on the VC development process in an emerging economy context such as Nigeria. The paper commences with a review of the literature, exploring the central tenets of VC funding, using institutional theory as a theoretical framework. The next section describes the methodology adopted for the study, followed by the analysis and discussion of the findings, from which the conclusions are drawn. Finally, implications for theory and policy are discussed, based on the research results.

The Theoretical Framework

How and why VC is established in emerging economies

A central tenet of this paper is that the facilitation of economic development to enable an emerging economy's transition to maturity requires a more diverse and sophisticated entrepreneurial finance escalator to enable potential high growth business development and optimisation (see Lerner, 2010, Mason & Owen, 2016). The efficient flow of risk finance along the finance escalator is crucial to business development and the wider economy (Mason & Brown, 2013; North et al 2013; Nesta, 2009), particularly as innovative businesses are major job and income generators (Lerner, 2010; Nesta, 2009). However, innovative businesses, notably younger ones without trading track records face information asymmetries for which effective due diligence is prohibitively expensive for prospective financiers to undertake and invest (Carpenter & Petersen, 2002). This results in Modigliani and Miller's (1958) finance market imperfections – leading to finance supply gaps along the finance escalator.

The finance escalator (Nesta, 2009) adapts Berger & Udell's (1998) theory of decreasing opacity to financiers as firms become more established. In essence, it suggests that as information asymmetries are reduced over time with the establishment of business trading track records a wider range of finance becomes available to them (North et al., 2013).

(Insert Table 1 here)

Institution Theory

The term 'institution' broadly refers to the formal rule sets (North, 1990), *ex ante* agreements (Bonchek & Shepsle, 1996), less formal shared interaction sequences (Jepperson 1991), and

taken-for-granted assumptions (Meyer & Rowan 1991) that organizations and individuals are expected to follow. These are derived from rules such as regulatory structures, governmental agencies, laws, courts, professions, and scripts and other societal and cultural practices that exert conformance pressures (DiMaggio & Powell 1991). These institutions create expectations that determine appropriate actions for organizations (Meyer & Rowan 1991), and also form the logic by which laws, rules, and taken-for-granted behavioural expectations appear natural and abiding (Bruton et al. 2010)

There is a growing, but relatively nascent literature on establishing VC in emerging markets (Da Rin et al., 2011; Lingelbach, 2015). Much of it is based on the public sector intervention theories drawn from more mature markets embodied in, for example, Lerner (2010), Murray (2007), Murray et al. (2009). Lerner (2010) states that a key principle of more successful VC markets is that the public sector has intervened to develop them, noting the examples of Israel and New Zealand, whilst Cumming & Johan (2016) note the case of Australia. Mason and Owen (2016) draw on this in their exploration of small emergent VC markets (including mature economies such as provincial Canada and UK regions as well as the Estonian transitional economy) to establish a series of tenets for a more holistic institutional approach to VC development. A key emerging theme is that institutional and regulatory approaches are essential – particularly to emerging economies (Lingelbach, 2015), as they can provide the stability to raise investor confidence and encourage inward investment from experienced foreign VC fund managers. Furthermore, that where government policy interventions are required these are often most effective when they operate in a market-led way which co-finances private VCs – encouraging and leveraging additional private investment and allowing expert private VC fund managers to take the lead in portfolio investment selection and management (Baldock & North, 2015; Lerner, 2010; Mason & Owen, 2016).

The key questions that arise out of the emerging market theories (Lingelbach, 2015) are how best to establish institutional and regulatory frameworks to facilitate effective establishment of VC? Lingelbach (2013) establishes a three-stage model progressing through enabling, co-financing, diffusing and replicating. This underlines Lerner's (2010) argument that the aim of public intervention is to enable appropriate market conditions to encourage private co-finance and generate diffusion of VC skills. This may operate through importing experienced VC fund managers from more mature markets, as in the case of US VCs operating in Israel and New Zealand, and then replicating their operation locally through a new breed of local VCs who learn from the demonstrator effect of the public funded VCs. This is effectively Lerner's virtuous circle of emerging VC market development, but as he suggests, it requires the institutions and regulations and networks of business/finance support, including financial intermediaries (accountants and lawyers) for it to come to fruition.

A major problem for emerging markets is their lack of regulation, appropriate institutional frameworks for VC and volatility which is unsettling and off-putting to investors (Bruton et al., 2002; Lingelbach, 2015) – either adding to transaction costs, or prohibiting VC activity altogether (Li & Zahra, 2012). Given that VC is a long-term high-risk investment activity with a typical fund cycle of 10-12 years, stability is crucial, which is a key finding of Lingelbach (2015). Lerner (2010), Lerner & Tag (2013) and Mason & Owen (2016) highlight the importance of having a legal vehicle for VC, such as the Limited Partner (LP) 10-year model successfully adopted from the US in Israel and the UK (Avnimelech & Teubel, 2006).

Examining the need for stability in developing VC markets, notably in emerging economies, Li & Zahra (2012) explore 'uncertainty avoidance' (Hofstede, 1991) in terms of formal and

informal institutional approaches across 68 developed and emerging country economies. They find that formal institutional stability in the form of consistent regulation such as low tax and transparent bankruptcy laws (Bergara et al., 1998; Bruton et al., 2010) alongside certain informal institutional factors are important to the development of VC (Ahlstrom & Bruton, 2006).

Informality refers to the customs and cultural constraints which bound society (North, 1990; Urban & Kujinga, 2017) and it is possible for these to offer belied assumptions (Huntington, 2000) that can support VC activity (Li & Zahra, 2012). These could for example involve informal trusted networks.

Mason & Owen (2016) recognise that successful nurturing of VC markets requires a holistic overarching policy approach which builds on Gilson's (2003) simultaneity of VC engineering theory – developing entrepreneurship and finance in tandem within an entrepreneurial finance ecosystem. This requires pipeline development of businesses (Mason & Brown, 2013), evaluation of changes in the entrepreneurial finance escalator in terms of the availability and complementarity of different types of finance – such as between business angels and VCs, public co-finance of VC schemes to encourage private investment into finance escalator gaps, finance networking and intermediaries, and investment exit market opportunities to enable optimal portfolio company exit value and recycling of returns into new investments.

Given the importance of creating stable environments for investors (Bruton et al., 2002), it is necessary to focus on the institutional requirements of VC. This has led to proposals that the most suitable model is through the operation of a State Investment Bank (Mason & Owen, 2016; Mazzucato & Penna, 2016), with powers to develop long term integrated business

support and finance policy. This holistic view is enshrined in theories which highlight the importance of antecedent factors such as fund raising and integrated support structures and networks to facilitate VC development. A further element of the development of VC in emerging markets is the increasingly transnational nature of the investment market (Lerner, 2010), which is facilitated by appropriate institutional and regulatory environment to attract inward investors and VC fund manager skills (Mason & Owen, 2016).

Venture capital in Nigeria

A Nigerian government policy known as the Structural Adjustment Programme (SAP) was introduced in 1986 as a result of the failure of previous governments' financial policies to achieve a desirable economic growth against the backdrop of a failing economy (Agundu & Dagogo, 2009). The introduction of SAP and the economic conditions at the time (import restrictions, rationalisation of government expenditure and financial liberalisation) resulted in the growth of SMEs in Nigeria. SAP was stopped because it lacked sustainability and was incapacitated by public sector bureaucracy. As a result of this, the finance window meant to provide assistance to SMEs became history. There was a perceived retrogression in the area due to inappropriate financing strategy which resulted in low profitability (Ollor & Dagogo, 2009).

In order to remedy these perceived problems, a program known as the Small and Medium Enterprises Equity Investment Scheme (SMEEIS) was introduced as a more sustainable equity based financial strategy. In contrast, Abereijo & Fayomi (2007) suggest that it was the Central Bank of Nigeria (CBN), in response to the problem faced by SMEs regarding the lack of access to capital, which introduced a method of financing for SMEs through equity financing i.e.

Venture Capital. This was done after finding out that debt financing did not do enough to bear the risks associated with SME start-ups.

The scheme required all commercial banks to save 10% of their profit before tax for equity investment and the promotion of SMEs that met guidelines stipulated by the bankers committee. The aim of the funding was to reduce the burden of interest and other financial charges expected under normal bank lending. On the other hand, Abereijo & Fayomi (2007) argue that SMEs need more than just capital in the economically depressed market of Nigeria. They suggest that SMEs need highly focused and on-going assistance in a number of areas such as financial controls and marketing. Both Abereijo & Fayomi (2007) and Ollor & Dagogo (2009) agree that previous policies put in place to aid the growth of the SME sector were not adequate and resulted in the birth of VC in Nigeria. Similarly, Abayomi-Olukunle (2015) argues that as competition builds in the industry and global firms build capacity and expand geographically, the Nigerian Government should take steps, as a matter of priority, through changes in regulatory approach as well as amendments to existing laws, to deepen the VC market in Nigeria.

Presently, there are only 20 active VCs (see Table 2 below) out of the few listed at <http://www.vconnect.com/nigeria/list-of-investment-venture-capital-firms> and 22 business angels (<https://angel.com/nigeria/investors>) operating in Nigeria seeking to provide seed, early stage and growth finance in various sectors including Clean Technology, Consumer Internet, Enterprise Software, Financial Services, Health Care, Food and Beverages, Logistics, Webhosting, Social Media, Fashion, Supply Chain, 3D Printing, Film Production, Film Distribution, Sensors, Craft Beer, etc.

(Insert Table 2 here)

In summing up, the literature reviewed in this study suggests that institutional structures and legal regulations appear critical to VC development in emerging economies/markets (Scheela & Van Dinh, 2004). Therefore, this study applies the institutional theoretical framework to the little researched area of Nigerian VC to answer the research questions of how institutional environment influences VC development in an emerging economy and how institutional deficit might be addressed to improve the operation of VC.

Methodology

Research approach

Since the study is to investigate the VC development process in countries with underdeveloped institutions, Nigeria is deemed suitable because it is characterised as significantly lacking fully developed institutions. Because this study is exploratory, it adopts a qualitative approach which involves semi-structured, face to face interviews. The qualitative approach was based on the assumption that individuals construct their own meanings from their experiences (van Manen, 1990). The use of this approach provided a basis for greater understanding which is useful for theory-building. A crucial feature of this approach is its capacity to elicit descriptions, explanations, and evaluations (Yin, 2014) of every aspect of how and why the lack of a fully-developed legal and financial environment impacts on the development of a robust VC market.

Sample selection

The interviews were conducted with 4 VCs who operate in Nigeria, 5 entrepreneurs who were not able to secure VC funding for their ventures, 5 entrepreneurs who secured funding, a government minister and a member of staff from the Nigerian Federal Ministry of Finance and

Economic Development as key informants. In order to gain access to government officials, a 'gate keeper' was used (Stockport & Kakabadse, 1992). The 'gate keeper' was a relation of the third author who had set up his venture using VC funding and as a result had a number of contacts. Therefore, the participants were purposively selected because the researchers were interested in companies which secured or failed to secure funding and to be able to have access to them.

This choice of sample enabled the aims of the study to be more effectively achieved as the VCs, entrepreneurs and the government officials provided unique insights and enhanced the richness and depth of the data collected, despite the small sample size (Ekanem, 2007). Angel investors were excluded as the focus was specifically on VCs. Although the sample was too small to be representative, the match pairing of types or sectors of successful and failed businesses of similar development stage across a range of sectors was unique and the VCs actually represent a high proportion as there are only a few active in Nigeria (see Tables 4 and 5). The four VCs in table 5 were identified and selected from table 2 with VC2 and VC4 being foreign, while VC1 and VC3 are Nigerian with an international strategy.

Data collection

The aim of the interviews was to gain a better understanding of what all parties involved in VC funding were looking for, and what all parties are actually able to deliver. Respondents were given a copy of the questions to be asked in the interview in order to give them time to prepare and allow for any possible objections or clarifications to be raised and addressed before the interview commenced. This approach helped in putting the mind of the respondents at ease by reassuring them that they were better placed to answer the questions being asked as well as affording them plenty of time to come up with their answers.

Although the interviews followed a pre-determined topic guide, respondents were encouraged to go into as much depth as possible. This led to other questions naturally being raised as more information was provided. As a result of this, each interview lasted for at least an hour and a half, while the longest interview took two and a half hours to complete. Each participant was interviewed once. Since the study was exploratory, examination of archival data/records was not carried out.

The interviews aimed at entrepreneurs took the form of a personal open-ended reflective interview where each participant was asked to narrate their life history in business from start-up to present. They provided details of the owner-managers' background and personal biographies such as age, education and training, and experience (Ekanem, 2007). They also focused on the motivations for starting the business and the problems the business is facing. This helped to reveal the major issues of the study and was also useful in building rapport (Gill & Johnson, 2010). They were also asked about the factors influencing their attitudes in attracting funding from investors.

In addition to information regarding their background, the interviews aimed at the VCs and government officials were focused on the main challenges facing the VC industry in Nigeria. Questions covered the efforts of the government to stimulate/encourage investment in Nigerian businesses by companies and the impact of the legal system, bureaucracy, tax incentives, policies and regulatory framework in helping or hindering investment opportunities in Nigeria. VCs were also asked about what they look for when deciding on a venture in which to invest.

With the verbal agreement of the participants all the interviews were tape recorded, on the understanding that the material provided would be treated as confidential. In all interviews, the

interviewer took the opportunity to review meanings of what was heard (for example, ‘Did I hear you emphasise that...’, ‘Would this be a fair interpretation ...?’, ‘Is my understanding correct that ...?’).

Data analysis

The data in this study were collected and analysed using an inductive process of recording, tabulation, coding, and constantly comparing emerging codes and categories with data until meaningful ideas emerged (Yin, 2014). Categories were allowed to emerge according to the topics emphasised by each participant, such as sources and types of VC funding, perception of them and challenges faced with respect to the influence of government institutions. The process of analysing the data began as soon as the researcher started collecting data. It was ongoing and inductive as the researcher was trying to make sense of the data collected (Shaw, 1999).

The data analysis utilised a set of techniques such as content analysis and explanation-building technique (Yin, 2014). Content analysis involved listening to and transcribing the tapes, reading the transcripts to list the features associated with the challenges faced by individual owner-managers, VCs and officials and establishing categories which were then developed into systemic typology. These features included attitudes of owner-managers, VC selection criteria, and the effect of institutions.

Explanation-building technique allowed series of linkages to be made and interpreted in the light of the explanations provided by each respondent (Yin, 2014). For example, attitudes and investment behaviour by both VCs and business owners emerged from a comparison of field notes and transcriptions. The aim was to build a general explanation based on cross-case analysis. These techniques are very effective when investigating contemporary phenomena within its real-life

context where the boundary between phenomenon and context are not clearly evident and multiple sources of data are used (Yin, 2014).

The inductive nature of the analytical process was reflected in the approach to coding data. Rather than being based on a set of preconceived, standardised codes, categories and sub-categories were produced for indexing and the data derived from the case study firms. The codes took the form of ‘code domains’ which made explicit key contexts, actions, meanings and relationships (Fisher, 2004), based on themes and processes identified from the transcribed interviews, whilst informed by the guiding frame of reference identified in the initial literature review. The approach to coding allowed for ongoing modification of, and adjustment to, the coding framework, as the analysis unfolded. Integral to this overall coding framework was a hierarchical ordering of the codes, which allows for the conducting of content analysis at different levels of aggregation (Fisher, 2004). The coding was used to select quotations made by informants to illustrate or emphasise a particular development issue within a case study firm. Thus, within each case, quotes are selected and used to make explicit a key dimension or activities under examination, such as what VCs look for when deciding on a venture in which to invest. Use of the overall coding framework allows for contextual identification of relevant explanatory and clarifying quotes.

Findings

The study consisted principally of 10 SMEs seeking VC funding, of which five successfully secured VC funding, and 4 VCs concurrently operating in Nigeria. These are profiled in tables 3, 4 and 5 below together with their case summary findings. Extracts from the interviews with the firms’ owners and VCs are presented in this section.

(Insert Tables 3; 4; and 5 here)

Attitude of Nigerian-based entrepreneurs in attracting VC funding

Analysis of the attitude of the Nigerian small business owners towards external funding revealed a number of factors, including; lack of VC industry aggregation and integration, inability to use assets as security, corrupt practices and lack of networking opportunities.

Lack of VC industry aggregation/integration

A major challenge emerging from the SME and VC interviews was the lack of integration in the Nigerian VC industry resulting in fragmented and complex funding especially from business angels (BA). In other words, the industry was not acting holistically. The owner of a fashion business, who failed to raise VC funding, stressed:

“The problem is insufficient VC available. The only equity funding is fragmented funding from Business Angels (BA) which is often too small and can be complex and time consuming in terms of the arrangements involved. We have to avoid them as they can be time wasting and insufficient. But from the regulatory and policy point of view something has to be done. The industry should be treated holistically rather than fragmented. Regulations and policies directed at venture capital can be envisaged with BA industry development in mind.” (C5).

This business owner was clearly discouraged from BA funding but was seeking far more funding than BAs could provide. They were also discouraged by the lack of aggregation and integration of the industry. This failure was associated with institutions relating to financial,

political and regulatory matters which the owner of the fashion business described as *“important sources for entrepreneurial opportunity and encouragement.”*

Terms of funding/security

The firms interviewed indicated that they would like prompter access to funding within certain time parameters and to be able to use their assets as a security. This is to allow them to maintain market leadership and business ownership. The owner of a creative consultancy emphasised:

“The timing is of the essence when you need capital for your business. I run the risk of losing the business to the investors if for one reason or another I can’t retain the market lead I have now because I didn’t obtain finance in time. The Nigerian government should take steps to regulate the industry through relevant regulatory authorities since there is no government loan guarantee scheme.” (C3).

Apart from timing parameters, the owner of a business in the technology sector, who had received VC funding, drew attention to the speed of expected returns by VCs:

“We were lucky because we are in a highly innovative business with the prospect of an immediate return. But I think this can be properly coordinated by relevant government agencies to enhance a greater degree of cohesion. For example, there should be a policy which allows companies to use their assets as security without any risk to the capital. I think this can relieve the pressure on businesses.” (C6 - Technology sector).

This quote indicates that VCs are under pressure to generate returns within a relatively short time period, usually between 5-7 years of investment. Entrepreneurs' concerns over early investment exits and potential loss of ownership suggest institutional failing which requires government intervention in the area of security regulation by allowing the assets of target companies to be used as security.

Corruption

Another reason the respondents in the study did not secure VC funding is corrupt practices in VC industry and lack of trustworthy people to introduce them to these sources of funding. It was suggested by the respondent that unless they knew someone to introduce them either directly or through a third party, then there was no way they would be eligible for funding:

“In Nigeria it’s all about who you know... if I had gone to school with any of the funders or our parents were friends, I would have received funding with reasonable rates without introduction or having to show too much documentation. I think there should be some form of corporate law reform in Nigeria to check this form of corruption. At the moment company regulation is centralised and centralisation allows all manner of corrupt practices.” (C5)

This suggests the lack of a fully-developed transparent legal and financial environment to curb VC industry corruption. The government minister interviewed as a key informant agreed: *“Institutions are the rules of the game in every country. They are supposed to be enforcement agencies strongly associated with positive economic growth. At the moment we are still struggling in that direction.”*

In support of decentralisation of company regulation to check corruption, one company CEO (C10) who was able to obtain funding said, *“We were able to raise capital because of our membership of a trade association.”*

Lack of networking opportunities

Another entrepreneur (C8) who had obtained VC explained that *“an investor found us at a pitch event and decided to reach out to us”*. The quote suggests the lack of networking opportunities which could be a value-added activity. The staff member of the finance ministry interviewed, described the difficulty in the VC industry as: *“limited networking opportunities and trust brought about by decreasing political confidence, lack of transparency and accountability and corruption which adversely affect social relations.”* These are informal institutional conditions, which negatively influence entrepreneurs seeking equity capital.

What VCs look for when deciding on a venture in which to invest:

What VCs consider before investing in a venture included; cost of due diligence, lack of a professional association and stable regulation, proximity/lack of infrastructure, and undeveloped stock exchange/ exit strategy.

Cost of due diligence

Recurring themes with regard to VCs investment selection criteria focused on the cost of due diligence and attractiveness of the venture, and the possible future returns or prospects of the venture (also known as Ex-Ante). This also extended to their appetite for risk, the market size, customer adoption and competition. Ability to monitor their investment and the terms of the deal were also mentioned as being important for VCs. One VC explained:

“We spend longest time monitoring investment performance and playing a hands-on role. Therefore, we need to understand the environment (legal, financial and regulatory) very well for prudent decision-making regarding investments and stages of funding. We need to have faith and confidence in the environment as well as the venture itself, including the value and potential of its products, services and markets. This is useful for Nigerian businesses in the context of the current state of economic and infrastructural development.” (VC1).

These factors allow VCs to complete their due diligence and ultimately decide if the venture is worth investing in. In effect, the VCs were emphasising that the business proposition must be right and marketable - scalability in terms of domestic market and exports is vital. They acknowledge that considerable ‘hands on’ time will be crucial to developing seed/early stage funded ventures over time and that an improved infrastructure and stable regulatory environment will help. This resonates with the government minister’s remarks that *“fully developed institutions can reduce the cost of due diligence and transactions costs by reducing uncertainties and establishing good structures to facilitate interactions.”*

Lack of professional association, entrepreneurial education and regulation

With regard to investing in a venture opportunity which is situated in an emerging market, VCs pay particular attention to the business management team. Finding suitable quality and professional managers is a significant problem for VCs in Nigeria due in particular to poor entrepreneurial knowledge and corruption. One interviewed VC emphasised:

“There is a need to educate managers about the mechanism of the VC market as well as promoting understanding of the exact requirements of the Nigerian market for angel (BA) investors” (VC3).

The quote demonstrates the need for a professional body that can provide entrepreneurial education, including financial management and research, as well as feed into policy formation at the grassroots level to create greater understanding amongst entrepreneurs. With regard to the nature of regulatory and policy reform, VC4 prioritised corporate law since *“it is central to the efficiency of the asset class.”* Only when there are clear and demonstrably enforceable regulations can a stable financial VC market flourish.

Proximity/poor infrastructure

The ease with which VCs are able to travel to the venture location plays a significant role in their selection criteria. This is exacerbated in a developing country with poor infrastructure and also a potential pitfall for overseas investors who can ensure local knowledge through ‘boots on the ground’ (Mason & Owen, 2016) via a representative based in the city (or within a commutable distance) of where the investee company is based. This allows VCs a “hands on” approach when it comes to providing management team assistance, advice or resolving any issues. Ease of travel to the portfolio company location is significant and helps to reduce VC monitoring cost, as VC4 indicated:

“Sometimes the best way to get your point across or address an issue is to have a face to face meeting, but you don’t want to spend half of your day getting there, having a 2-hour meeting, and then the other half of your day getting back because of the bad road network and underdeveloped internet infrastructure. That’s time

that could have been spent being more productive. The limit is 2 hours travelling time. Any time longer is a no-go.”

The quote demonstrates that poor road and ICT infrastructures have an impact on VC investment. This is a very traditional finding (Baldock & Mason, 2015) and underpins the typical emergence of VC activity which is based on infrastructure and institutional development.

Underdeveloped Stock Exchange/Exit strategy

VC investment exit strategies were explored, in the expectation that these form an important part of their selection criteria. VC1 remarked:

“In this climate, if the venture is profitable enough there will always be people who will want to take it off your hands and make money. However, this is a very important point of consideration and we worry about it a lot as there is no fully developed and properly functioning stock exchange to provide a primary exit route strategy.”

The interviewed VCs argued that typically, IPOs offer a potentially attractive exit route. Therefore, in the absence of properly functioning institutions such as a Stock Exchange, Securities and Exchange Commission and Corporate Affairs Commission, the regulation and operation of IPOs presents a serious problem in Nigeria.

Discussion

Having examined how the institutional environment influences VC development in the emerging Nigerian economy and how potential deficits in this setting might be addressed, the evidence, presented through the lens of institutional theory, provides insight into the VC development process. This discussion explores how the study develops on the theoretical perspective to provide conclusions for policy development for Nigeria and potentially translate to other emerging economies.

The fragmentation of funding, linked with discouragement of entrepreneurs due to the institutional environment supports Lingelbach's (2015) argument that formal institutional change can improve both the quality and quantity of opportunity-oriented entrepreneurs and the impact of these changes may vary with time – depending on the suitability of the institutions and regulations imposed.

Additionally, the problem with early stage risk finance was that the amount was often too small and risky to make it worthwhile for equity investors such as private VCs as the cost of due diligence is too high (North et al., 2013). NESTA (2009) and SQW (2015) explain this mismatch between demand and supply to be due in part to '*thin markets*' where there are limited numbers of, and, therefore, limited interactions between, investors and entrepreneurial firms. This is particularly the case in an emerging – under-developed – market, such as Nigeria. It leads to a lack of understanding among those seeking finance of what it takes to attract equity finance (both businesses and their professional advisers), and a lack of insight and knowledge among those seeking to invest on the strengths and opportunities presenting in an area. There are also demand-side factors, including the lack of awareness of finance schemes, and need for education on the usefulness/role of equity finance. Furthermore, there is the issue of 'market readiness', which relates to business owners and entrepreneurs being able to identify and

present clearly the market opportunities for their business i.e. issues around communicating the projects that require funding, and the potential markets that they will be able to target (Mason & Kwok, 2010).

The attitude of the participating entrepreneurs was also expressed in terms of time parameters, loss of control and the speed of expected return by VCs, which the institutional environment needs to take on board. These can reflect unrealistic expectations on the part of the parties. It seems that sanctioning a transaction by way of resolutions and proof of solvency at the time of the transaction could provide the required comfort (Abayomi-Olukunle, 2015).

With regard to the speed of expected return, SQW (2015) states that equity investment in new firms is a long-term game, noting the typical ‘J-curve’ pattern of expected returns; positive returns to funds are unlikely to be achieved until around five to seven years after the first investment (depending on sector type). The patience and time required to generate returns can, therefore, lead to under-investment in funds focused on early stage firms from institutional investors. This uncertainty results in investment going to sectors/firms with the prospect of more immediate returns, rather than those that require further research and development, even though the latter may ultimately generate greater benefits (Mason & Owen, 2016; SQW, 2015). This point of investment horizon can be seen as an institutional failing of VC in mature markets (Mason & Owen, 2016; Baldock, 2016), leaving gaps for equity capital, requiring government intervention.

Previous studies (e.g. Pierce et al., 1989; Sabherwal et al., 2003) suggest that increased levels of uncertainty increase the propensity to continue investment. In contrast to the escalation of commitment theory, this study indicates that high uncertainty decreases the propensity to

continue investment. Brundin & Gustafsson (2013) and Li & Zahra (2012) postulate that the higher the level of uncertainty avoidance, the weaker the positive relationship between the level of formal institutional development and the level of VC activity. Therefore, in theory at least, a more stable institutional environment would lead to greater certainty and longer-term investment.

The lack of personal introduction suggests a relationship between informal institutional environment and VC development. Perhaps in Nigeria, and indeed other developing economies, decreasing political confidence specifically on issues of transparency and accountability, correct appointments, crime, inflation, the widening income gap, and corruption undermine social relations and trust. Such adverse informal/normative institutional conditions, in all probability negatively influence the development of VC – or at least government backed VC - and may result in entrepreneurs with good ideas not wanting to be involved with government departments or agencies since they anticipate some corrupt disadvantages in transacting with them. Abayomi-Olukunle (2015) argues that Nigeria should really consider decentralisation of company law to check corrupt practices and create competitive tension between state governments for the growth of the industry.

This is where a well-developed networking opportunity would be an advantage. Networks are informal institutions (Ahlstrom & Bruton, 2006) and could provide an opportunity where both VCs and investee companies could network together or where the VCs can work with the government officials in order to get necessary approvals for an investee company (Scheela & Van Dinh, 2004). Various studies (Baldock & Mason, 2016; Lerner, 2010) point to the need for better knowledge and networking developed through more sophisticated intermediary

services to address failure in developed economies, but would be likely to be lacking in emerging economies.

Van Halen et al., (2015) indicate that businesses which participate in an acceleration programme or a pitch event are more likely to secure greater capital than businesses that do not. They further state that in most cases, businesses do not receive any funding from foreign investors until local investors are ready to vouch for them. *“The commitment from the local investor puts the wheels in motion to get other investors involved”* (van Halen et al., 2015, p.11).

In terms of what VCs look for before investing, the evidence suggests that they would prefer to invest in a venture where the management team is sufficiently high quality and professional, with a proper understanding of their business valuation as well as good understanding of the industry as a whole. Payne et al. (2009) suggest a better understanding of the decision-making process can enable more prudent decisions regarding investments and stages of funding. Without this understanding, small business owners would prefer to be on friendly terms with the investor so that they would bend the rules and not been so stringent when conducting their due diligence. Due diligence is of course what would be expected of a responsible investor, especially in the aftermath of the GFC (North et al., 2013). A fully-developed legal and regulatory environment based on common law can help in the understanding of the industry and reduction of the cost of due diligence (Scheela & Van Dinh, 2004). Both formal and informal institutions can provide the proper incentives and help reduce transaction problems; the more developed these institutions, the more they are likely to reduce transaction problems and encourage VC funding (Li & Zahra, 2012).

Properly functioning institutions, especially financial institutions as well as political stability (Lingelbach, 2015) would also help in the provision of adequate and sufficient information to reduce the risk of moral hazard and adverse selection caused by information asymmetry (Carpenter & Peterson, 2002). The correction of the institutional deficit may also require stable markets, regulations, taxes, export facilities and assistance. Extant literature only reported favourable perceptions of the regulatory institutional environment with positive association with feasibility (Urban, 2013). However, this study shows that the regulatory environment has a real and significant impact on VC development since inappropriate institutional development and corruption lead to a negative impact on VC development in Nigeria.

With regards to proximity, the finding supports Lutz et al. (2013) which suggest that even in economies with a dense infrastructure such as Germany spatial proximity between investor and investee impacts the likelihood of an investment. Although there is a counter-argument that VCs will source the best deals irrespective of location, many commentators consider spatial proximity between investor and investee to play an important role in VC (Amini, 2013; SQW, 2015). However, as discussed earlier, well-developed institutions with adequate infrastructure and good quality of public services (Lingelbach, 2015) as well as sector syndication with trusted and established local investment partners (which do not appear to exist in the Nigerian context) can overcome this problem (Abell & Nisar, 2007).

Lastly, exit strategy was important to VCs in emerging economies. Jiang et al. (2014) argue that although the role of VCs in IPO is well rehearsed in developed markets, limited attention has been paid to the role of VCs in IPOs by SMEs in emerging markets. This is probably because VCs are prepared to sell their investment via trade sales, syndication, or sale to larger later stage VCs. Again, a fully developed institution provides improved macroeconomic factors

that directly improve exit strategies by developing a stock market and alternative private equity options (Scheela & van Dinh, 2004). It is a key argument that exit strategies are crucial to the development of VC markets, enabling recycling of funds and encouraging more investors into the market and an IPO feeder market is integral to this (Baldock, 2016; Mason & Owen, 2016).

Conclusions

The aim of the study was to investigate the VC development process in an emerging economy lacking the fully-developed legal and financial institutions necessary to support VC financing. The findings suggest that VCs require stable trusted institutional frameworks, regulations and policies, alongside clear exit strategies as well as informal institutions enabling networking for VC development.

Therefore, the question for Nigeria is not whether VC should be regulated, but the extent to which it should be. Although a legal framework exists to assist VC fund establishment in Nigeria, the vast majority of local VC funds are set-up in offshore centres, with the effect that such locally-sponsored funds can easily fall outside the scope of state regulators (SEC). Currently, no separate regulation for foreign VC investors operating in Nigeria exists and consequently there is no requirement for offshore VC funds to register with the SEC (Abayomi-Olukenle, 2015).

Although Aldrich (2008) argues that even in some of the most developed countries in Europe, VC is very limited through cultural, institutional and normative barriers and not serving wider socio-economic goals, we argue that it has a role and could be nurtured in the right cultural and institutional situations to not only make the environment more attractive to private VC development (i.e. stable economy/politics/low tax), but also to counter the problems of agency

failures through sufficient regulation and policy support which may range from poor experience and knowledge leading to poor selection, to potential corrupt practices and selection bias (adverse selection and moral hazard issues).

This study contributes to the literature on VC and institutions by providing a more fine-grained analysis of the impact of institutions on the VC development process in the Nigerian emerging economy context. From the finance supply-side, it indicates that local VCs require upskilling, highlighting the need for attracting imported skills sets, which are likely to be enhanced through institutional and regulatory stability and harmony with international regulations and taxes (Lerner, 2010), alongside improved informal support and referral networks (Li & Zahra, 2012).

The study also contributes to the argument that the funding gap for SMEs which poses a threat to economic growth in emerging economies should be narrowed. It is critical to the economic prospects of the emerging economies that viable potential high growth SMEs are provided with the financial support they need (Lerner, 2010; North et al., 2013). It is believed that the challenges outlined in this paper can contribute to closing the SME finance gap, increasing SMEs contribution to GDP and substantial job creation in the emerging economies.

From the demand-side, government needs to stimulate entrepreneurial awareness of equity finance through training and promotion to facilitate investment readiness and overcome thin markets (Mason & Kwok, 2010). This also extends to greater emphasis on entrepreneurship teaching in higher education (e.g. the Finish Aalto University model, SQW, 2015). A public relations campaign could highlight success stories and encouraged entrepreneurial role models for new ventures to use VC. Furthermore, a central point of access - “a one-stop-shop” -

dedicated website to access funding options would help. Thus, the right environment must be created for the provision of private capital to SMEs.

The government in Nigeria is complex. Whilst the Ministry of Trade and Investment is the key Nigerian government department to address the development of VC, the Corporate Affairs Commission, Trademarks Registry, Nigeria Immigration Service, Securities and Exchange Commission, Nigerian Stock Exchange and SMEDAN are also key ministries. Therefore, a more cohesive mechanism, perhaps through a state investment bank (Mazzucato & Penna, 2016; Mason & Owen, 2016) is required to develop an appropriate coordinated regulatory and policy response (Abayomi-Olukunle, 2015).

Another possible way of correcting the institutional deficit is to introduce a broker service between the VC firm and the investee firm. The literature examining mature VC market operations confirms that firms which use well informed VC finders are invariably more successful in their search operations, alongside serial entrepreneurs (Lerner, 2010; North et al., 2013; SQW, 2015). Within the emerging market scenario, the broker would need to be trusted and able to speak the language of both the investor and investee and could act as a guarantor for both. In the absence of an efficient legal system this could act as a form of arbitration agreed by both parties prior to concluding the deal.

The government should also facilitate the successful establishment of IPO exit strategy for VCs by establishing an IPO taskforce to provide direction to SMEs. The taskforce can help to reduce the information asymmetry through availability of information and greater transparency for investors. This will also allow VCs to provide intensive monitoring services which enhance firm quality and reduce underpricing in IPOs (Jiang et al, 2014).

Other areas of support needed from practitioners include better understanding of the different types of funding available; better understanding of what VCs look for in business plans/applications; help in improving investment-readiness skills among businesses; and better understanding of the benefits of taking external finance, as well as the downside.

The main limitation of the study is the scarcity of information available on the emergence of VC in Nigeria and few suitable comparative studies. The paper therefore makes a significant and timely contribution to addressing this deficit in Nigeria. It contributes to the debate that institutions are significant to VC development and that new and potential high growth ventures in emerging markets should be assisted to become viable prospects to attract international VC, develop local VC markets and generate sustainable impact investment markets.

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